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SUBJECT: PERU LNG: PROGRESS AND CHALLENGES

REF: (A) Lima 3686 (B) Lima 742

11. SUMMARY: The Peru Liquefied Natural Gas (LNG) project is proceeding apace, bringing gas from the Camisea gas fields through to pipeline to LNG plant and marine terminal on Peru's coastline. A 2010 export target should deliver \$200 million in GOP revenues and community projects per year, with annual exports of four million metric tons of liquefied natural gas, potentially worth a billion dollars. President Alan Garcia has publicly expressed full support for this project, in which U.S. company Hunt Oil is the operator with a 50 percent share. There is little Peruvian opposition to the LNG project but continuing complaints about Camisea. At a September 27 Inter-American Development Bank (IDB) public forum, civil society and GOP speakers noted the economic importance of Peru LNG. There were no concerns raised about Paracas Bay. NGO critics focused on rupture risks of the Camisea liquids pipeline (which will also carry Peru LNG liquids) and social impacts on the indigenous residents near the gas fields and pipeline. Project implementers said they are addressing these concerns by working to ensure the pipeline's integrity and improve their work with indigenous communities. While the GOP, the USG, the IDB and NGOs should work together to make sure environmental and social plans are fully implemented, Post recommends support for IDB lending to Peru LNG.
END SUMMARY.

OUTLINE OF PERU LNG

12. The Peru LNG project is on schedule, with five main components - gas extraction, pipeline, expansion of the Pisco fractionation plant, and a new liquefaction plant with a marine terminal at Pampa Melchorita, 169 km south of Lima. The anticipated economic effect of the project makes Peru LNG a vital cornerstone of GOP development plans. It includes combined projected annual royalties of \$200 million for the central and local governments, and public works projects for communities. The Ministry of Energy and Mines (MEM) has approved the Environmental Impact Assessments (EIA) for Concession Block 56, the new gas pipeline and LNG plant/marine terminal. The operator of Block 88, Argentine company Pluspetrol, will submit a revised EIA for that block covering proposed changes to the pipeline route that will be shared by Peru LNG.

¶3. Peru LNG, a Peruvian corporation, is a consortium consisting of Hunt Oil Company (50 percent partner), SK Corporation of South Korea and Repsol-YPF of Spain. Peru LNG contracted with the GOP to build and operate the Peru LNG plant, offshore Marine Terminal and a gas pipeline connecting the plant to the existing Camisea pipeline (Ref B). Peru LNG awarded a subcontract for construction of the Marine Terminal in August. PlusPetrol, Argentine company leading the original Camisea extraction consortium, will operate the gas fields in Block 56 that will feed the Peru LNG project. PlusPetrol will also fractionate the gas liquids from Block 56 along with the liquids from current operations of Block 88, dividing the liquids into propane, butane, naphtha and diesel.

¶4. Pluspetrol will pay the GOP a sliding (per external market indicators) royalty of 30 percent to 38 percent for gas sold to Peru LNG. Fifty percent of the royalty is earmarked for regional and municipal governments, and universities of the Cuzco Department (the "gas canon") and 14.25 percent for the local governments and universities of the Ayacucho, Huancavelica, Ica, and Lima departments (through a fund called "FOCAM").

¶5. Note: FOCAM was designed to complement the canon reserved for extraction area communities, and covers all departments along the Camisea and Peru LNG pipeline routes. The gas canon is similar to the mining canon; requirements for use by communities are the same. The formula is different: the mining canon is paid off income taxes while the gas canon is based on royalties (and eventually on income tax after investment is recovered). Camisea Canon and FOCAM funds transferred by the GOP are already in the millions, which the local governments have been largely unable to spend for capacity reasons similar to the situation with the mining canon. End Note.

¶6. Repsol-YPF contracted to purchase the entire Peru LNG output. Repsol's sales plans are not being formulated in Peru and are still uncertain, but Mexico and the U.S. West Coast remain logical destinations per Repsol executives. With President Garcia's recent political overtures to Chile, LNG export to Chile (small volumes as demand is not great) is now more conceivable. A new proposed use for LNG may be within Peru, although the market is comparatively small. The same 600x compression that makes LNG attractive for the U.S. market has led the Irradia joint venture to develop a project to truck or ship LNG to Peru's inland cities. Initial capacity of a plant will be 150,000 gallons/day with an initial investment of \$170 million.

GOP AND MEDIA SUPPORT FOR PERU LNG

¶7. President Garcia announced to the press on September 12 his full support for Peru LNG, saying that if completed on time by 2010, LNG export will give a strategic push to Peru's economic capacity and will attract significant investment, foreign and domestic. Garcia applauded the 600 Peruvian workers laboring at the plant site and the overall project as proof that international companies have faith in Peru as a site for investment. Not surprisingly considering the reputation of Garcia's APRA party for internal discipline, the rest of the ministries have been supportive. MEM Vice Minister Pedro Gamio told Econoff September 15 that while the MEM from top to bottom firmly believes that Peru LNG is an important and well-planned project, the MEM and its environmental Department plan to oversee every bit of construction to make sure all environmental, engineering and social concerns are addressed. The new president of Environmental Commission CONAM told Econoff on September 27 that CONAM will take an active role (which it did not with Camisea) to ensure that environmental concerns are met with what appears to be a solid, well-planned project.

¶8. Prime Minister (and key APRA official) Jorge del Castillo continues to fully support Peru LNG. As President of Congress' Investment Committee, he was instrumental in clearing the way for Peru LNG project approval during the Toledo Administration, despite APRA's opposition to Toledo in many areas.

¶9. COMMENT: Garcia's public support tracks with private statements as reported by our industry and government contacts. While he had called for "renegotiation" of Camisea contracts, his public and private remarks were never directed to the 2006 Peru LNG export deal; Garcia's campaign was directed at ensuring that the domestic price of Camisea natural gas and gas liquids remained below

international prices. Camisea renegotiation talks are ongoing but in any event should have no bearing on Peru LNG. END COMMENT.

PUBLIC AND MEDIA REACTION

¶10. Public and media reaction to the Peru LNG project in the wake of Garcia's September 12 statements have been minimal, in line with the overall high support that the Peruvian public has of the project. While the Camisea pipeline contract, as it relates to damage provisions for rupture, continues to figure in the news, this has not been cited as a reason to oppose Peru LNG. In the midst of a steady public campaign by the Garcia administration to address poverty - in which Peru LNG revenues figure as a funding source, there has been virtually no criticism of the export project.

¶11. Though the largest Congressional bloc was elected under the banner of statist candidate Ollanta Humala, who favored national over foreign investment, Peruvian legislators have not called for changes to or restrictions on the Peru LNG project.

¶12. Local and international NGOs are critical of Camisea as it relates to social development for indigenous peoples near the gas fields and pipeline routes. The IDB held its fourth semi-annual Camisea public forum in Lima on September 27; while various consortia and GOP presenters described the Peru LNG project in the context of the existing Camisea project, none of the many vocal critics singled out Peru LNG. Econoff discussed with a number of NGOs the recent letter by several to the IDB, expressing concerns with Peru LNG. The thrust of NGO concerns are completion of IDB conditions from its Camisea loan, with the added concerns over the possibility of future ruptures in the liquids pipeline and mitigation of any effects in Paracas Bay.

POST ASSESSMENT

¶13. In the IDB conference, all of the active NGOs appeared willing to work constructively to make Peru LNG responsive to environmental and social needs. The IDB has scheduled a further meeting with interested parties on September 29 in Lima, which Embassy and NGOs will attend. While none of the NGOs had a firm list of the IDB Camisea loan conditions that needed completion, we agreed to discuss this on September 29. It is Post's assessment that NGOs will want to delay a vote on the IDB Peru LNG loan until satisfied that Camisea loan conditions have been met; most of conditions deal with community development.

¶14. The few vocal critics of Peru LNG are fishermen in Paracas Bay and the Peru LNG site, Pampa Melchorita. The MEM's Environmental Director and industry representatives told Econoff that these groups, as well as residents near the Peru LNG site, are seeking either compensation for claimed loss of revenue or jobs.

REVENUE AND BENEFIT PROJECTIONS

¶15. Pluspetrol -- the same Argentine firm that operates the Malvinas gas fields for the Camisea project, and the gas liquids fractionation plant in Pisco/Paracas Bay - has been drilling since May. Current estimates - basically agreed upon by industry and the GOP -- for gas proven reserves in Block 56 and the adjacent Camisea Block 88 indicate 10.87 trillion cubic feet (tcf), while total reserves (including probable and possible) are 16.69 tcf in 2005. These reserves are enough to comfortably cover Peru's future domestic needs as well as feed the LNG plant for decades; MEM estimates of domestic demand (which contain the unlikely assumption that no more hydroelectric plants will be built) are 4.0 tcf for the next 20 years, while Peru LNG's needs would be 4.2 tcf.

¶16. There are no firm estimates yet for the value of Peru LNG's plans for community development projects. Peru LNG is reluctant to quantify projects as negotiations with various government entities are ongoing. Pluspetrol described on September 27 its community development activities, but acknowledged to Econoff that the firm has not done a good job of publicizing them. Econoff pointed out the continuing need for drinking water, wastewater and sewage treatment for the Paracas Bay area, and Pluspetrol expressing willingness to consider such projects, which are in line with President Garcia's stated priority for water projects. (Note: with

no evidence of negative effects from the marine terminal and fractionation plant, and significant (but not complete) cleanup of fishmeal plant effluents, municipal waste remains the major polluter of Paracas Bay. End Note.)

GOP: 35,000 jobs created

¶17. The MEM confirmed to Econoff that PERU LNG job creation estimates are reasonable: 35,000 direct and indirect Peruvian jobs created during construction of the extraction facilities, pipeline, expansion of the fractionation plant, LNG plant, sea wall and Marine Terminal. The foregoing estimates do not take into account the number of government workers who will be engaged in oversight and development activities, from the Ministries of Economy, Energy, Health and Transportation, plus their associated sub-agencies. Once perforation of the Lot 56 fields is completed, there will be very few additional jobs in the gas extraction and separation facilities, a positive sign for concerns over non-indigenous workers having negative effects on local indigenous peoples, some of whom are arguably in "voluntary isolation" (although this concept is debated). Many new permanent LNG pipeline maintenance jobs will be created, as well as the staffing needs for the plant and marine terminal.

GAS FIELDS IN BLOCK 56

¶18. There may be some social impacts on the communities closest to the Block 56 gas fields, although use of existing nearby separation and pumping facilities for Peru LNG products will reduce them. However, with more workers in the area, there is a possibility of increased communicable diseases. DIGESA, the Ministry of Health's Inspection Service, is actively involved in monitoring the situation. DIGESA has not opposed the Peru LNG project, but it has raised concerns that it will monitor as the gas fields are developed. The MEM has held over eight workshops and at least one public hearing has been held (with translators) in the native communities nearest the Block 56 gas fields.

¶19. At the September 27 meeting, Pluspetrol laid out extensive plans for augmenting education, health and development support for the jungle communities, in cooperation with Ministries of Health and Education programs. While a number of native representatives criticized the slow pace of community development, most acknowledged that private industry was making substantial efforts but that the GOP needed to pay more attention in the entire lower Urubamba River area to health, education and job creation.

NEW AND EXISTING GAS PIPELINES

¶20. Peru LNG will use the 32-inch pipeline that runs from the extraction area to the beginning of the Andes Mountains. The jungle portion of the pipe was designed so that it could accommodate the high flows that would eventually be required if more gas was discovered in block 56 or other nearby blocks. (Note: Petrobras's Block 58 and Repsol/Burlington-Conoco's Block 57 are also adjacent to lot 56 and as yet untapped sources of gas. End Note.)

¶21. The Camisea consortium built the first-leg 32-inch pipe so that operators of future gas exploitation, such as Peru LNG's Block 56 can use the pipeline that is in the most difficult terrain in the whole route, with no need to create more environmental or social impacts, nor suffer the risks of shifting terrain that have caused problems for the liquids pipeline in the same stretch of jungle. Even so, the Camisea 32-inch jungle gas pipe has never had an accident. The existing liquids pipeline, which has ruptured, will be used for Peru LNG liquids, with increased flow.

¶22. Peru LNG will have to build around 400km of new pipeline from the end of the jungle portion to Pampa Melchorita. Peru LNG's proposed route for the new pipeline closely parallels the existing pipeline until it diverts more northerly to reach Pampa Melchorita. While the environmental concerns of carving a pipeline path over the Andes are undeniable -- revegetation of the right of way, migration to the roads created during construction, for example - these are challenges that can be overcome with proper oversight. It is clear from Econoff's conversations with Hunt and GOP officials that criticisms of revegetation efforts by TGP on the Camisea pipeline have highly sensitized companies to the need to meet these concerns.

Nevertheless, this is an area where the GOP, USG, IDB and NGOs could work together to make sure it is handled properly.

¶23. Though few concerns have been raised about the planned Peru LNG gas pipeline, legitimate concerns exist that with a history of liquids pipeline ruptures, increased flows through it could lead to more ruptures. It is still premature to ascertain the causes of all of the five ruptures, with three audits in various stages (the GOP's independent audit contract was awarded last week). Although the MEM's September 27 public presentation made clear that most ruptures are due to weather/topographic pressures on the liquids pipe, there may have been several defective pipes or welds. There have been no more ruptures since the March 2006 rupture. We anticipate that the intense public scrutiny will lead to more ongoing assessment, rebuilding and rerouting of liquids pipe. The coming rainy season will be a test of these efforts.

PERU LNG PLANT AND MARINE TERMINAL

¶24. LABOR: Construction of the plant is on schedule and the subcontract for construction of the marine terminal was awarded in August. On an August visit by Treasury officers and Econoff, the construction site was well excavated and full of vehicles and workers. The construction site is currently employing 600 local workers, evenly divided between residents of the two nearest communities, Chincha and Canete (each around 25 km to the South and North).

¶25. Past reports of labor issues at the plant (including several months ago when visiting PDAS was advised not to visit the plant) were based entirely on rivalry between the two towns. When it was perceived that Peru LNG had more employees of one town than the other, the other town organized a protest to disrupt construction operations until the payroll was balanced. Peru LNG's construction manager told Econoff that while Peru LNG agreed to hire from both towns equally, and never intentionally favored one or the other, the company has learned the hard way to pay close attention to the exact makeup of the payroll. In addition, the professional employees of Peru LNG have more or less evenly split their residences between the two towns, in order to fairly apportion the demand for housing, goods and services that the Peru LNG outside employees bring to the area.

¶26. ENVIRONMENT: As with Econoffs earlier visit with regional ESTH Hub Director in February 2006, the entire Peru LNG property at Pampa Melchorita (169km South of Lima) is completely barren desert -- waterless and without vegetation. On this visit a group of pelicans rested on the beach; otherwise there was no evidence of animal life, including insects. There was an increase in human life surrounding Peru LNG's property, where there are more shacks (most uninhabited) erected by speculators. These individuals hope (according to discussions Econoff has had in the nearby towns of Chincha and Canete) to benefit when the Plant's construction makes the surrounding land even more valuable, or they hope to get a job with the plant builders.

¶27. FISHERMEN: During Econoff's February visit, there was no evidence of artisanal (small-scale, within 5 nm of shore) fishing activity. The coast, out to 1000m and beyond is without islands or underwater topographic relief. During the August visit, fishermen were visible with regular beach fishing posts spaced out along Peru LNG's portion of the beach (otherwise on either side no fishermen were visible). The Peru LNG construction manager stated that the fishermen were new arrivals and explained that the fishermen now claimed that these spots marked their traditional fishing grounds. Peru LNG has chosen not to dispute this, realizing that there will be compensation claims when the shore facility for the marine terminal is eventually constructed. (Note: while the science is debatable, there is a solid argument that the seawall, when eventually constructed in the otherwise featureless seascape, will concentrate fish that will use it for shelter, thereby making nearby fishing more efficient. End Note.)

EXPANSION OF FRACTIONATION PLANT

¶28. In late August 2006 Econoff toured Fractionation Plant with visiting Department of Treasury officers. The PlusPetrol operations manager showed us the location of the buildings for the expansion.

In order to handle the increased volume of gas liquids that will come with the increased gas extraction in Block 56, the monthly liquids flow through the pipes will increase. A second set of condensing structures will be built on the existing PlusPetrol property. Flow through the pipes that run from the plant undersea to the marine terminal will simply increase, so there will be no need to use larger pipes. There has never been a rupture associated with these pipes.

¶29. Neither will ship traffic to the marine terminal increase, according to Pluspetrol whose plan is to have larger ships dock to transport the liquids products. The PlusPetrol manager explained during the August 2006 visit that due to a combination of limiting factors -- the time it takes to dock and undock a ship (only one ship can dock at a time), the slow 5-knot speed used while in the bay, the time required to pipe the liquids product aboard and weather conditions (high waves and the infamous Paracas winds) that make safe loading operations possible only for part of the day -- the marine terminal cannot easily handle increased ship traffic. (Note: what has increased substantially is tourist boat traffic, to a current 50/day. End Note.)

¶30. Econoff and Treasuryoffs also toured TGP's "CityGate" pipeline terminus 35 km South of Lima, home of the master control center for both existing pipelines and the distribution point for domestic gas use in the Lima area. TGP officials said that the increased liquids flow does not pose appreciable additional threats to the liquids pipeline integrity, because the rupture issues have been more involved with earth pressure (landslides) on the pipes, on which the overall monthly flow has no bearing. The regular valve spacing for the liquids pipeline means that no matter what the flow is, only a fixed amount of liquids can spill in a rupture. CityGate will continue to monitor and control flow through the liquids pipeline as it handles increased flow from Peru LNG liquids.

COMMENT

¶31. The GOP considers the Peru LNG project a vital component of efforts to reduce poverty and make Peru a net energy exporter within four years. We believe Hunt and its partners have learned lessons from the Camisea experience and will bring high standards to the project. Nevertheless, some holdover from the Camisea project, and the inevitable environmental and social sensitivities of a project that spans so great an area, make it prudent for the USG to monitor, and recommend that the IDB monitor as part of any loan:
--Camisea liquids pipeline integrity issues;
--Effects on Paracas Bay of expanded fractionation plant and liquids flow, and liquids shipping;
--Environmental effects of sea wall construction (polluting, discharges, etc.);
-- social/environmental effects of Block 56 production;
-- restoration/preservation of new pipeline right of way.

¶32. We do not anticipate that problems with any of these items will cause us to recommend withdrawing full support for the project. We are rather encouraged by the solid engineering and social development plans by the consortium. The IDB's posting of an environmental/gas industry expert to Lima to oversee due diligence for a Peru LNG loan, and compliance with Camisea loan conditions, is a welcome development. The indigenous groups, environmental NGOs, industry representatives and GOP officials all expressed to Econoff, at the September 27 Camisea meeting, a desire to work together to make Peru LNG work. While there remain some disgruntled stakeholders, the Camisea model of public participation, canon/FOCAM funding mechanism and a separate ombudsman for the project is arguably a model that could be exported to other sectors in Peru (like mining) and to other nations with controversial large projects.

STRUBLE